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Supreme Court, U.S.
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No._____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

ENRON OIL & GAS COMPANY,

Petitioner,

v.

BRUCE BABBIT, Secretary of the Interior, UNITED STATES DEPARTMENT OF THE INTERIOR, ERASMO GONZALES, Area Manager, Houston Area Audit Office of the Minerals Management Service, and MINERALS MANAGEMENT SERVICE,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Do this Court's decisions in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and its progeny permit a federal court, in reviewing agency actions, to give deference to that agency's interpretation of an unambiguous federal statute?

2. Given that the United States' reserved royalty share of oil and gas production from public domain lands is exempt under principles of sovereign immunity from state and local taxation, is a federal lessee permitted to exclude from royalty payments to the United States monies received in reimbursement of taxes assessed only against the lessee's non-exempt working interest share of production under 30 U.S.C. § 226 (1982), which defines the royalty to be reserved under oil and gas leases covering said lands?

PARTIES TO THE PROCEEDING

In addition to the parties listed in the caption,[1] Arkla Producing Company, Coastal Oil & Gas Corporation, Columbia Gas Development Corporation, Meridian Oil, Inc., Oxy U.S.A., Inc., Sonat Exploration Company, TXP Operating Company, Transco Exploration Company, Mountain States Legal Foundation, and Independent Petroleum Association of Mountain States were amici curiae in support of petitioner in the proceedings below.

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1. Affiliated companies of Petitioner Enron Oil & Gas Company are as follows: Enron Corp. is the 80% majority owner of Enron Oil & Gas Company, and each subsidiary of Enron Oil & Gas Company is wholly owned.

Manual Lujan was designated as a party in the lower court proceedings in his capacity of Secretary of the Interior. Bruce Babbit is now Secretary of the Interior, and is substituted as a Respondent party in this petition pursuant to SUP. CT. R. 35.3.

Erasmo Gonzales was designated in the lower court proceeding as Area Manager, Houston Area Compliance Office, Minerals Management Service. As the result of recent governmental reorganization, that office has been renamed the Houston Area Audit Office.

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BRUCE BABBIT, Secretary of the Interior,
UNITED STATES DEPARTMENT OF THE INTERIOR,
ERASMO GONZALES, Area Manager, Houston Area Audit
Office of the Minerals Management Service, and
MINERALS MANAGEMENT SERVICE,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Enron Oil & Gas Company ("Enron") petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A) is reported at 978 F.2d 212 (5th Cir. 1992). The opinion of the district court (App. B) is reported at 778 F. Supp. 348

(S.D. Tex. 1991). The decision of the Interior Board of Land Appeals (App. C) is reported at 106 I.B.L.A. 394 (January 1989).

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1992, and a timely petition for rehearing was denied on January 27, 1993. (App. D). Jurisdiction was originally vested in the United States District Court for the Southern District of Texas pursuant to 28 U.S.C. § 1331. Appellate jurisdiction was vested in the court of appeals pursuant to 28 U.S.C. § 1291. Jurisdiction for review by writ of certiorari to this Court was vested pursuant to the provisions of 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND REGULATIONS

The relevant provisions of 30 U.S.C. § 226 (1982), which are contained in Appendix I.

The relevant provisions of those regulations issued by the Department of the Interior found at 30 C.F.R. § 206.103 (1987), which are contained in Appendix J.

STATEMENT OF THE CASE

A. Procedural History

The Minerals Management Service ("MMS") is the agency of the United States Department of the Interior[2]

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2. Respondents Bruce Babbit, Secretary of the Interior, Minerals Management Service and Erasmo Gonzales, Area Manager, Houston Area Audit Office of the Minerals Management Service are collectively referred to as "DOI."

which assesses and collects royalty payments on oil and gas leases covering public domain lands. When oil and gas leases are issued by DOI, federal lessees such as Enron take "working interests" in the minerals in public lands, and DOI retains a royalty interest. When producers like Enron sell their gas, they receive direct payments for the gas delivered and may also receive reimbursements for state taxes which are assessed upon the working interest share of minerals they have produced ("tax reimbursements").

Because the states cannot tax the royalty interest owned by the federal government, Enron and other producers do not receive tax reimbursements from those to whom they sell gas for that share of the gas which is attributable to the federal government's interest (the "royalty share").

Nonetheless, in 1986 the MMS issued three orders to Enron compelling it to include in its royalty payments to the government a share of the tax reimbursements Enron received for the sale of Enron's working interest share of gas. The first order, dated May 7, 1986, required Enron to pay $1,052,597.41 in additional royalties alleged to be due under Enron's federal oil and gas leases covering public domain lands in Wyoming and Utah for the years 1978 through 1983. (App. H). By order dated August 19, 1986, DOI additionally directed Enron to pay $685,253.50 in late payment charges with respect to those allegedly underpaid royalties. (App. E). Finally, by order dated September 2, 1986, DOI directed Enron to pay all royalties on all tax reimbursements that it received with respect to all natural gas produced from all of Enron's federal onshore leases, beginning January 1, 1984. (App. F). Enron appealed these orders to the Director of the Minerals Management Service, who denied Enron's appeal on June 29, 1987. (App. G). Enron then appealed the Director's decision to the Interior

Board of Land Appeals, which affirmed the Director's decision. (App. C).

Enron then filed its complaint in the United States District Court for the Southern District of Texas seeking judicial review of the decision of the Interior Board of Land Appeals and declaratory relief that royalty is not payable to DOI on ad valorem and severance tax reimbursements received by Enron from its natural gas purchasers for the years involved. The parties filed cross-motions for summary judgment. Amicus briefs were filed by other federal lessees which were also adversely impacted by this ruling as well as the Mountain States Legal Foundation and the Independent Petroleum Association of Mountain States. The matter was referred to Magistrate Frances Stacey who issued her Memorandum and Recommendation of Magistrate. (App. B). The district court adopted the Magistrate's recommendation. (App. B at 11a-12a). Enron timely appealed the decision of the district court to the court of appeals, which issued its decision dated November 30, 1992, upholding the ruling of the district court. (App. A). Enron timely filed a Petition for Rehearing with that court. By order dated January 27, 1993, Enron's Petition for Rehearing was denied. (App. D).

Enron now seeks this Court's review of the decision of the Fifth Circuit Court of Appeals.

B. **Factual Background**

The facts giving rise to this case are substantially undisputed. Enron owns several oil and gas leases covering the United States' mineral estate in lands located in the states

of Wyoming and Utah. These oil and gas leases[3] were issued by DOI pursuant to the provisions of the Mineral Lands Leasing Act of 1920, 30 U.S.C. § 181, et seq. (the "MLLA").

Enron produced natural gas from these oil and gas leases which it sold to various purchasers under long-term gas purchase contracts. These contracts provided that the purchase price to be paid for gas delivered was to be the maximum lawful price permitted by law. During the years in question, this price was limited by the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301, et seq. In addition, Enron's gas purchase contracts provided that the purchaser would reimburse Enron for ad valorem and severance taxes on gas assessed by the states and localities.

Federal leases granted by DOI must provide for a royalty of not less than "12-1/2 per centum in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226. This royalty share of production can be taken by DOI either in "amount" (i.e., by in-kind delivery of the government's share of minerals produced) or in "value" (i.e., by payment in cash for the value of the government's share of production). Oil and gas owned by DOI or attributable to its royalty interest is exempt from ad valorem and severance taxes assessed by state and local governments under principles of sovereign immunity and under the specific state statutes and constitutional provisions creating and implementing these taxes. Thus, oil and gas attributable to the interest of Enron as DOI's lessee (Enron's working

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3. In the proceedings below, certain leases covering Indian lands were also at issue. By way of this Petition, Enron is not seeking review of the court of appeals' ruling on the leases governed by 25 U.S.C. § 396(a)—396(g) (1983). These Indian land leases constitute only four of the many at issue.

interest share) is subject to local taxation, while the production of the DOI's royalty share is not.

Enron paid severance and ad valorem taxes to local and state governments in the states of Utah and Wyoming assessed against its working interest share of the natural gas produced from oil and gas leases issued by DOI. *See* WYO. STAT. §§ 39-6-301 to 309 (1977) and WYO. STAT. §§ 39-2-301
to 305 (1977). *See, also,* UTAH CODE ANN. §§ 59-2-101 to 1372 (1987 and Supp. 1991) and UTAH CODE ANN. § 59-5-67 (1987).

Enron paid DOI exactly what it received from its purchaser for the government's share of gas produced. Enron did not receive tax reimbursements for the DOI's royalty gas and as a result did not pay DOI as though it had received such reimbursements. Nonetheless, DOI contends that it is entitled to a portion of Enron's tax reimbursements, even though (1) the DOI's royalty share of production is exempt from taxation and (2) the DOI's interest is a separate and distinct property interest in production under the MLLA and other applicable law. DOI asserts that it is entitled to a portion of Enron's reimbursement when it has paid no part of the tax and the reimbursement is made without respect to non-taxable production. This of course reduces the tax reimbursements received by Enron, the party actually burdened with the tax. On the other hand, DOI receives its full royalty share of the proceeds received from the sale of production plus a share of Enron's tax reimbursement. The net effect is that DOI receives royalty on a higher value than the net value received by Enron for its working interest share. In this respect, the position of DOI represents a significant case of over-reaching.

REASONS FOR GRANTING THE WRIT

A. Introduction and Summary.

In the present case, this Court is presented with two basic issues: (1) whether the court of appeals failed to follow the correct standard of review established by this Court in considering DOI's interpretation of 30 U.S.C. § 226 and (2) whether, contrary to Congressional intent expressed in 30 U.S.C. § 226, and other applicable portions of the MLLA, the United States may demand as a royalty a portion of the funds representing a reimbursement of the taxes assessed against Enron's non-exempt share of production and for which Enron was solely responsible for payment. The first of these issues falls squarely within the provisions of SUP. CT. R. 10.1(c) because the court of appeals applied a standard of review "that conflicts with applicable decisions of this Court." The second issue is a profoundly important question of federal law which this Court has not heretofore addressed. *See* SUP. CT. R. 10.1(c). Furthermore, the position adopted by the court of appeals is based upon legal interpretations of the nature of an oil and gas royalty interest which are squarely in conflict with decisions of numerous relevant state courts of last resort, justifying review by this Court under SUP. CT. R. 10.1(a).

B. The Court of Appeals Failed to Employ the Correct Standard of Review to the DOI's Interpretation of the MLLA.

The royalty to be reserved in DOI leases is defined under the provisions of the MLLA:

> Such leases shall be conditioned upon the payment by the lessee of a royalty of *12-1/2*

> *per centum* in amount or value *of the production removed or sold from the lease.*

30 U.S.C. § 226 (1982)(emphasis added).

The first rule of statutory construction is that if language is unambiguous, its terms must be applied by the court. *See, e.g., Badaracco v. Comm'r of Internal Revenue*, 464 U.S. 386, 398-99 (1984).

The court of appeals did not apply, or even consider, standard rules of statutory construction in this case. Instead, the Court simply deferred to the DOI's interpretation of the MLLA. Specifically, the court, in purported reliance upon *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), found the following standard of review to be applicable:

> [W]here the determination at issue involves a statute's interpretation, an agency's interpretation of a statute it administers should be upheld if it is based on a "permissible" construction of the statute.

(App. A at 5a).

Chevron involved a challenge to the validity of regulations issued by the Environmental Protection Agency ("EPA") implementing and interpreting the provisions of the Clean Air Act, 42 U.S.C. §§ 7401-7642 (1987). After finding that Congress had not directly addressed issues covered in the regulations and had impliedly delegated implementation of the act to EPA, this Court upheld the decision of EPA and validated its regulations. *Chevron*, 467 U.S. at 866. This Court made it clear, however, that absent statutory silence or ambiguity, agency interpretations of a

statute are afforded no deference. *Id.* at 843. Such deference to an agency's construction of a statute is not appropriate where the statute is unambiguous and constitutes a complete misinterpretation of this Court's ruling in *Chevron*.

1. *Chevron* and its Progeny Mandate that No Deference be Accorded DOI's Interpretation of 30 U.S.C. § 226.

In the instant case the court of appeals should have scrutinized the DOI's position under the standards set forth in *Immigration and Naturalization Service v. Cardoza-Fonseca*, 480 U.S. 421 (1987), where this Court reiterated the principle announced in *Chevron*:

> The judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent. [Citations omitted.] If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, intention is the law and must be given effect.

Cardoza-Fonseca, 480 U.S. at 447-48, *quoting Chevron*, 467 U.S. at 843.

Section 226 of the MLLA defines the royalty of DOI, is unambiguous, and expresses Congress' intent that oil and gas leases issued by DOI reserve to the United States as a royalty a per centum "of production." Accordingly, it was improper for the court of appeals to defer to the statutory interpretation of DOI.

This Court's decision in *Federal Reserve Bd. v. Dimension Fin. Corp.*, 474 U.S. 361 (1986), confirms that *Chevron* cannot be used to support an agency's interpretation of an unambiguous statute. There, in holding that the Federal Reserve Board exceeded its authority by attempting to redefine "demand deposit," this Court again returned to the language of *Chevron*:

> If the statute is clear and unambiguous, 'that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.' ... The traditional deference courts pay to agency interpretation is not to be applied to alter the clear express intent of Congress.

Dimension Fin. Corp., 474 U.S. at 368, *quoting Chevron*, 467 U.S. at 842-43.

Similarly, in this case, DOI may not change the unambiguous language of the MLLA. DOI may not amend the term "royalty" or the nature of its interest[4] as a percentage "of production." DOI may not change the unambiguous statutory language to arrogate to itself something other than a share of oil and gas produced, or the value of that share of the production.

2. The Court of Appeals Failed to Apply Standard Rules of Statutory Construction to the Provisions of the MLLA.

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4. As noted *infra* at section 3.C.3, 30 U.S.C. § 226's definition of DOI's royalty interest as a portion of production is consistent with the common law definition of "royalty."

As noted above the MLLA defines the DOI's royalty as "*12-1/2 per centum* in amount or value *of the production* removed or sold from the lease." 30 U.S.C. § 226 (emphasis added). This clearly means 12-1/2 percent of production. This royalty share of production may be taken in amount or, at the discretion of DOI, in value. That is, DOI may be paid the value of its royalty share of production.

The court of appeals misconstrues the statutory language, accepting the DOI's tortured conclusion that § 226 actually means "12-1/2 percent of the value of all oil or gas production," meaning that DOI would be entitled to 12-1/2 percent of the value of the entire gas stream. The court has no power to legislate the terms upon which DOI is to be paid royalty. The MLLA states that DOI's royalty is a percentage of production or the value of that percentage of production. DOI may not properly claim royalty on the value of 100% of the gas produced, and the court of appeals ignored the statutory language in upholding the position of DOI.

3. The MLLA Does Not Grant DOI Authority to Establish a Royalty Value which Includes Tax Reimbursements.

The court of appeals attempts to justify its failure to consider and apply appropriate rules of statutory construction to the language of the MLLA by implicitly holding this case to be one involving delegated interpretation. This is apparent from the court of appeals' citation to that portion of *Chevron* which authorizes agency regulation where statutes are silent or ambiguous. *See* App. A at 5a. The court of appeals, however, was simply wrong. While 30 U.S.C. § 189 of the MLLA does allow the Secretary of the Interior to promulgate appropriate regulations, and the applicable lease terms do

empower the Secretary of the Interior to establish reasonable royalty values, it is clear that the authority to establish reasonable royalty values is limited by § 226's unambiguous terms. Otherwise, the use of the term "royalty" becomes meaningless. The only consistent interpretation of § 226 is that DOI may establish a reasonable value for the government's royalty share of production, consistent with the statute.

C. The Court of Appeals Failed to Consider the Explicit Terms of the Mineral Lands Leasing Act of 1920.

1. The Court of Appeals' erroneous Characterization of DOI's Royalty Interest is in Conflict with State Royalty Law Canons Applicable to DOI Leases.

The MLLA specifically states that none of its provisions will be in conflict with the laws of the state in which the leased property is situated. 30 U.S.C. § 189 (1982). The MLLA further states that its provisions shall not be construed to affect the applicability of state law in determining the respective rights of the parties under DOI oil and gas leases. 30 U.S.C. § 187 (1982). Further, a body of federal common law has developed to the effect that the royalty interest of DOI must be interpreted consistent with the responsibilities and rights of private landowners issuing oil and gas leases. In *United States v. General Petroleum Corp.*, 73 F. Supp. 225 (S.D. Cal. 1946), *aff'd sub nom., Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950), the court was asked to determine whether or not royalty value was properly established by DOI under its oil and gas leases to General Petroleum. The court specifically

found that the government's rights and obligations as lessor of public lands are no different from those of any other lessor. *See, also, Standard Oil Co. of Cal. v. Hickel*, 317 F. Supp. 1192 (D. Alaska 1970), *aff'd sub nom., Standard Oil Co. of Cal. v. Morton*, 450 F.2d 493 (9th Cir. 1979).

2. The Court of Appeals Failed to Recognize that Royalty Payable to DOI Represents a Separate and Distinct Share of Oil and Gas Production and Must be Valued as Such.

The decision of the court of appeals that DOI is entitled to royalty on oil and gas production premised upon a value which includes reimbursement of state production taxes, when it in fact pays no tax, necessarily assumes that DOI's royalty gas is not to be valued separate and apart from gas belonging to Enron to which the tax reimbursement pertains. The court of appeals clearly so stated:

> Enron argues that tax reimbursements are not part of the statutory "value of production" for purposes of calculating royalties, and thus cannot be included by the DOI as part of "gross proceeds," since no state taxes are paid on the "government's share of royalty production." This argument, rejected by the District Court, the IBLA and this Court, rests on the *false distinction* between "government royalty share" and "working interest share."

(App. A at 8a)(emphasis added).

In this, the court of appeals is clearly incorrect. In fact, if allowed to stand, the court's conclusion represents a significant departure from well established, clearly understood principals of oil and gas law enunciated long ago by state courts of last resort.

3. The Royalty Interest of DOI is a Separate Share of Production under Existing Common Law.

The definition of a royalty interest[5] is universal and well established by state courts of last resort.[6] Williams and Meyers define royalty as:

> (1) The landowner's share *of production*, free of expenses of production.
>
> (2) A share of production, free of expenses *of production*....
>
> The landowner's royalty is frequently 1/8th production[sic], but it may be any other fractional share of production....
>
> * * *

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5. It cannot be disputed that the DOI's retained interest is in the nature of a royalty. *See* 30 U.S.C. § 226.

6. At common law, a royalty represented a share of the minerals mined in return for the privilege of extraction. *Ex parte Hanke*, 1 MONTAGUE & MCCARTHUR REPORTS, 247 (1829). *See* Blake, *The Oil and Gas Lease*, 13 S. CAL. L. REV. 407 (1940) (*citing* A NEW ENGLISH DICTIONARY ON HISTORICAL PRINCIPLES, 852 (Oxford Univ. Press 1914)). Royalty was, by definition, a share of the minerals produced, to be delivered in kind. Because of the physical difficulties that exist in delivery of a share of production in kind to a royalty owner, the concept of royalty as a money payment based upon the value of the royalty share of production was later adopted.

> Royalty may be payable in kind (that is, the royalty owner is entitled to *a share of the oil or gas as produced*), *or* it may be payable in money (that is, the royalty owner is to be paid in money for *the value* or market price *of his share of the product*).

H. WILLIAMS & C. MEYERS, MANUAL OF OIL & GAS TERMS 8, 1087-88 (1992)(emphasis added). *See, also, Veverka v. Davies & Co.*, 10 Kan. App. 2d 578, 705 P.2d 558, 561 (Kan. App. 1985); *McBride v. Hutson*, 157 Tex. 632, 306 S.W.2d 888 (1957).

The Supreme Courts of Wyoming and Utah, where the leases at issue are located, have adopted this general rule. In *Flying Diamond Oil Corp. v. Newton Sheep Co.*, 776 P.2d 618 (Utah 1989), the Utah Supreme Court defined a royalty interest as a "share of production, 'if, as and when there is production, free of expense of production.'" *Id.* at 629, *citing* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 8, 862-63 (1987). The same rule is of long standing in Wyoming, where the remainder of Enron's leases at issue are located. *See Cities Serv. Oil Co. v. Pubco Petroleum Corp.*, 497 P.2d 1368 (Wyo. 1978).

Wyoming and Utah law provides that the royalty interest of DOI is exempt from both ad valorem and severance taxes on oil and gas production. WYO. STAT. § 39-1-201(a)(i) (1977); UTAH CONST. art. XIII, § 2; UTAH CODE ANN. § 59-2-1101(2)(a) (1987 and Supp. 1991).

These exemption statutes recognize that the interest of DOI is separate from Enron's. Nevertheless, the court of appeals erroneously held that only a "false" distinction exists between Enron's working interest share of gas and DOI's royalty share.

It is thus clear that the royalty interest of DOI is a separate and distinct share of production under the law of virtually every jurisdiction that has addressed this issue and particularly the jurisdictions in which the leases in this case are located. The court of appeals' refusal to recognize this fundamental and long established principle of oil and gas law renders its decision utterly incompatible with decisions of the pertinent state courts of last resort.

D. This Court's Prior Decisions Dealing with the Issue of Sovereign Immunity Acknowledge the Distinction between Enron's Working Interest and DOI's Royalty Interest.

The decision of the court of appeals is based upon the notion that DOI is entitled to be paid a royalty based upon the "gross proceeds" received from all gas produced from Enron's federal leases, not upon the "gross proceeds" received for the government's royalty share of production. (App. A at 6a). This reasoning allowed the court to determine that the value of the government's royalty share of production should include tax reimbursements to Enron, even though DOI itself pays no tax, and accordingly Enron received no reimbursement with respect to DOI's tax-exempt royalty share. This premise is not only contrary to the existing decisions of state courts of last resort but with prior decisions of this Court as well.

It was originally held that oil and gas produced from or attributable to mineral interests owned by the United States was entirely exempt from state and local taxation. Subsequently, this ruling was rejected by this Court, which has ruled in a similar case involving Indian allottee leases that, while the interests of the government or allottees were indeed free from state and local taxation, the interests of the

lessees were not. *Oklahoma Tax Comm'n v. Texas Co.*, 336 U.S. 342, 354 (1949). This Court's reasoning in that case is premised upon the notion that the exempt interest is in fact a separate and distinct share of oil and gas produced from the leased premises and is therefore protected by the doctrine of sovereign immunity, while the interest of the lessees is not. *Id.* at 353-54. The Court stated:

> Nor, as has been noted, do the cases involve challenges to the immunity from state taxation of *royalty oil, the Indian's share of production.*

Id. at 353 (emphasis added).

In reaching this conclusion, the Court relied upon *Carpenter v. Shaw*, 280 U.S. 363 (1930). In *Shaw*, the state of Oklahoma attempted to tax a member of a tax-exempt Indian tribe on oil and gas produced from an oil and gas lease wherein tribal members reserved a 3/8 royalty. This Court ruled that the retained royalty of the tribal members was protected from state taxation under the doctrine of sovereign immunity. *Id.* at 368. Thus, the very notion of sovereign immunity as it applies to state taxation of oil and gas production from federal oil and gas leases assumes that the interest of DOI is a separate and distinct share of production against which the state cannot assess tax under the Constitution of the United States. Indeed, there is no other premise upon which the doctrine of sovereign immunity could apply to exempt DOI from taxation but not its lessees.

The court of appeals assumes, however, and in fact states, that there is no such thing as "the government royalty share," that instead it is merely a right to participate in moneys paid for the total gas stream. If DOI can participate in Enron's percentages of the total consideration received for

the sale of Enron's gas, then Enron's working interest in federal minerals should similarly "share" in the DOI's exemption from taxation. The plain statements and underlying theory of the court of appeals in this case simply cannot be reconciled with the decisions of this Court in *Oklahoma Tax Comm'n v. Texaco Co.* and *Carpenter v. Shaw*. In any event, it is apparent that given the fact that the issue was critical to the decision of the court of appeals, this Court should review the decision of the court of appeals and re-examine the applicability of the doctrine of sovereign immunity as it applies to state taxation of oil and gas produced from public lands.

CONCLUSION

It is respectfully submitted that this Court should grant certiorari to review the decision of the court of appeals in this case.

Respectfully submitted,

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April 27, 1993.

APPENDIX A

ENRON OIL AND GAS COMPANY and Belco Petroleum Corporation, Plaintiffs-Appellants,

v.

Manuel LUJAN, Secretary of the Interior, United States Department of Interior, Erasmo Gonzales, Area Manager, Houston Area Compliance Office, and Minerals Management Service, Defendants-Appellees.

No. 91-6161.

United States Court of Appeals,
Fifth Circuit.

Nov. 30, 1992.

Before JONES and BARKSDALE, Circuit Judges, and JUSTICE,[1] District Judge.

JUSTICE, District Judge:

Plaintiffs-appellants ("Enron") appeal the grant of summary judgment by the district court in favor of defendants-appellees, the Department of Interior and others (collectively "DOI"). 778 F.Supp. 348 (S.D.Tex. 1991). The issue on appeal is whether it was permissible and reasonable for the DOI-lessor to include state severance tax

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1. District Judge of the Eastern District of Texas, sitting by designation.

reimbursements, paid to lessee Enron by purchasers of its gas, as part of Enron's "gross proceeds," in calculating the royalty valuation of gas production from federal leases.

I. BACKGROUND

Enron leases federal public domain property in Utah and Wyoming from the DOI for the purposes of oil and gas exploration and production. From 1978 through 1986, Enron's charges to its oil and gas purchasers included state severance taxes assessed against Enron for production from these properties. Enron failed to include tax reimbursements from purchasers in calculating royalties owed to DOI. Following an audit, the Mineral Management Service ("MMS"), the agency within the DOI responsible for collecting and auditing royalties, determined that royalty payments were outstanding and issued orders: (1) on May 7, 1986, demanding additional royalties in the amount of $1,052,597.41 for the period of August 1, 1978, through December, 1983; (2) on August 19, 1986, demanding late payment charges in the amount of $685,253.50; and (3) on September 2, 1986, demanding royalties on tax reimbursements after 1983 in the amount of $435,304.64. Enron paid the specified royalties and late charge amounts under protest, and appealed to the MMS the method by which the DOI defined "gross proceeds" to include state severance tax charges. The MMS denied the appeal, and the Office of Hearing and Appeals, Interior Board of Land Appeals ("IBLA"), affirmed. The district court granted the government's motion for summary judgment.

We affirm.

II. STATUTES AT ISSUE

This appeal involves two statutes: the Mineral Leasing Act of 1920 ("MLA"), 30 U.S.C. §§ 181 *et seq.* (1982), and the Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. §§ 3301-3432 (1982). The leases at issue were granted under the authority of the MLA and are subject to its terms and those set forth in the rules and regulations of the Department of Interior.

A. *The Mineral Leasing Act*

Pursuant to Section 226(b) of 30 U.S.C., the Secretary of Interior is required to collect royalties, at a minimum, of twelve and one-half percent "in amount or value of production removed or sold from the lease." Section 189 of 30 U.S.C. authorizes the Secretary to promulgate all rules necessary to achieve the purposes of the MLA. Under this authority, the DOI formulated its regulation for calculations of royalty, which states in relevant part:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production ... for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof ....

30 CFR § 206.103 (1983).

The leases signed by Enron contain the language of the MLA and require a twelve and one-half percent royalty to be paid to the DOI on all "production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations." In addition, the leases state:

> [T]he Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all ... gas ..., due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters ....[2]

B. *The Natural Gas Policy Act*

Pursuant to the NGPA of 1978, lessees selling gas may exceed the maximum lawful price "to the extent necessary to recover [in relevant part] (1) state severance taxes ..." NGPA § 3320(a)(1). The States of Utah and Wyoming, where Enron leases properties, impose severance taxes on the production of gas. Enron sells gas for a price up to the highest amount allowed under law including, pursuant to the NGPA, any state severance tax amounts attributable to such sale.

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2. Oil and gas leases are "both conveyances and contracts." E. Kuntz, *Oil and Gas Law* 107 (1986). The method by which royalty is to be calculated is a contractual provision. *Id.* at 108. Under principles of contract law governing contracts between private parties, Enron would have a duty to perform the contract according to its terms, and failure to do so would constitute a breach. *See* 1 Arthur L. Corbin, *Corbin on Contracts* §§ 2, 3 (1963).

III. ANALYSIS

In this appeal, Enron challenges the DOI's decades-old method of including tax reimbursements, paid to lessee Enron by purchasers of its gas, in the royalty basis for calculation of the "value of the production removed or sold" from federal onshore leases. Enron argues that the DOI's method is arbitrary and capricious, since inclusion of tax reimbursements paid by purchasers in calculations of royalty assessments violates the NGPA, passed in 1978. In this relation, Enron alleges that the NGPA was intended to allow producers to receive the maximum legal price, undiluted by state severance taxes.

A. *Standard of Review.*

The district court's grant of summary judgment, upholding an order of the DOI, is reviewed *de novo* by this court. *Mesa Operating Ltd. Partnership v. U.S. Department of Interior*, 931 F.2d 318, 322 (5th Cir. 1991), *cert. denied*, -- U.S. --, 112 S.Ct. 934, 117 L.Ed.2d 106 (1992). Under the Administrative Procedure Act, this court cannot set aside the DOI's findings unless they are "arbitrary, capricious or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Moreover, where the determination at issue involves a statute's interpretation, an agency's interpretation of a statute it administers should be upheld if it is based on a "permissible" construction of the statute. *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc. et al.*, 467 U.S. 837, 843, 104 S.Ct. 2778, 2782, 81 L.Ed.2d 694 (1984). The agency's interpretation of its own regulation need only be reasonable, and not the only interpretation or the one the court would have reached if it were initially faced with the question. *Udall v. Tallman*, 380 U.S. 1, 16, 85 S.Ct. 792, 801, 13 L.Ed.2d 616 (1965). Because the MLA and NGPA are silent on whether the DOI

may properly consider state tax reimbursements in calculating "gross proceeds" for purposes of assessing royalties on Enron, this court must inquire only as to whether the agency's determination is a permissible interpretation. *Chevron*, 467 U.S. at 843, 104 S.Ct. at 2782.

B. *Inclusion of State Severance Tax Reimbursements in Calculation of Gross Proceeds is Permissible Under the Mineral Leasing Act and the Natural Gas Policy Act.*

The DOI's long-standing method of including state severance tax reimbursements from purchasers in the calculation of "gross proceeds" is a "permissible" interpretation and is supported by case law. *See Mesa Operating*, 931 F.2d 318; *Hoover & Bracken Energies, Inc.*, 52 IBLA 27, 88 I.D. 7 (1981), *aff'd, Hoover & Bracken Energies v. United States Dep't of Interior*, 723 F.2d 1488, 1492 (10th Cir. 1983), *cert. denied*, 469 U. S. 821, 105 S.Ct. 93, 83 L.Ed.2d 39 (1984) (emphasis added)("What is the value of production? Is it contract price, *or contract price plus severance?* The latter is the value of production for payment of royalties")[3] *CIG Exploration, Inc. v. Lujan*, No. 91-CV-0096-J, 1992 WL 390709 (D.Wyo. June 26, 1992) (granting lessor government's motion for summary judgment

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3. Enron attempts to distinguish *Hoover & Bracken* from the case at hand, arguing that *Hoover & Bracken* involved a communitization of the federal royalty share and other royalty shares. We agree with the decision of the IBLA that this argument is unavailing. Under 30 CFR § 206.103, the value of the Federal royalty gas is no less per unit than the value of other gas having the same characteristics. In either case, the value of a unit of gas is equivalent to what a customer will pay - and Enron's customers pay Enron the NGPA price and the state severance tax. Because Enron increased its gross receipts by allowing customers to reimburse it for state severance taxes, Enron has increased the amount of royalty it owes on its gas production.

and rejecting lessee's claim that the DOI may not include state tax reimbursements within a federal gas lessee's gross proceeds from the sale of leasehold production for royalty calculation purposes); *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973) (emphasis added) ("[T]he base value for computation of the federal royalty in this case must include both the gas purchase price *and the reimbursed severance tax*.").

The IBLA in *Wheless* stated its reasoning for including state severance taxes in royalty payment calculations, equally applicable to the case at bar:

> It seems obvious to us that the buyer is thus paying to the seller an amount greater than the established field price from the natural gas it purchases ... It follows, therefore, that it is reasonable to compute the Federal Royalty of the natural gas taken from this well on a unit value consisting of the field price ... plus the amount of severance tax reimbursed by the buyer.

13 IBLA 21, 80 I.D. at 603, (*quoted with approval in, Hoover & Bracken*, 723 F.2d at 1490).

The Fifth Circuit has recently held that, under § 110 of the NGPA, a seller of natural gas could be required to pay royalties on reimbursements for post-production costs that were not included in the ceiling price. *Mesa Operating*, 931 F.2d at 325.[4] Not distinguishing between § 3320(a)(1) and

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4. *Mesa Operating* concerned reimbursements for the costs of putting gas into marketable condition as provided for in NGPA § 3320(a)(2), whereas this case concerns reimbursements for state severance taxes provided for in § 3320(a)(1). The Fifth Circuit, however, did not

§ 3320 (a)(2), the court in *Mesa* held that where § 3320(a) of the NGPA allows a lessee to obtain more than the ceiling price from its purchaser, royalties should be based on the price paid: "The DOI-lessor simply obtains a flat percentage of all 'gross proceeds' whether they be within the ceiling price or exceed it under [§ 3320(a)], obtaining more royalty where the lessee obtains a greater price, including cost reimbursements, from the pipeline purchaser." *Id.*

Moreover, the DOI has consistently included state severance taxes in calculating gross proceeds for purposes of royalty calculations, and even modified its regulations defining "gross proceeds" to include tax reimbursements. 30 C.F.R. § 206.101 (1987). The IBLA has approved this method of calculation. *See Wheless Drilling Co.*, 13 IBLA 21 (1973). After *Wheless*, the DOI issued two notices affirming the approved practice. *See* Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases, 42 Fed. Reg. 22610-22611 (May 4, 1977) ("[u]nder no circumstances will royalty be computed on less than the gross proceeds accruing to the lessee"); Notice to Lessees of Federal Onshore Oil and Gas Leases, 42 Fed. Reg. 4546, 4548 (1977) ("gross proceeds include ... tax reimbursements").[5]

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differentiate between these two subsections. *Mesa Operating*, 931 F.2d at 326.

5. Enron argues that tax reimbursements are not part of the statutory "value of production" for purposes of calculating royalties, and thus cannot be included by the DOI as part of "gross proceeds", since no state taxes are paid on the "the government's share of royalty production." This argument, rejected by the district court, the IBLA, and by this court, rests on a false distinction between "government royalty share" and "working interest share." In addition, the DOI's interpretation of "value of production" is permissible, and thus must be followed. *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc. et al.*, 467 U.S.

C. *Inclusion of State Tax Reimbursements in "Gross Proceeds" Calculations is not Affected by Passage of the NGPA.*

Enron argues that Congress intended the NGPA to remove the DOI's discretion and authority to include the state severance taxes in calculation of "gross proceeds." This claim has been rejected by the Fifth Circuit in *Mesa Operating*, where the court, making no distinction between § 3320(a) reimbursements for state taxes (§ 3320(a)(1)), and marketable condition reimbursements (§ 3320(a)(2)), stated:

> [W]e are unconvinced that including [§ 3320(a)] reimbursements in the royalty-bearing 'gross proceeds' from the sale of gas necessarily thwarts Congress' intention to provide incentives for exploration ... Knowing that the FPC [Federal Power Commission] had allowed royalties on special relief prices in the past, it was for Congress, if it had intended the incentive to be greater than under the [Natural Gas Act], to provide that NGPA [§ 3320(a)] payments not be subject to royalty.

931 F.2d at 326. In addition, the NGPA is silent on calculation of royalties.

IV. CONCLUSIONS

Based on the foregoing, the district court's grant of summary judgment for the DOI was appropriate. The DOI's interpretation of the MLA is both permissible and reasonable. The DOI has historically included state severance tax

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837, 843, 104 S.Ct. 2778, 2782, 81 L.Ed.2d 694 (1984).

reimbursements in calculating "gross proceeds" for royalty assessments, and Congress has not disrupted this practice, either expressly or impliedly. Passage of the NGPA did not disrupt, and was not intended to disrupt, this long-standing practice. Moreover, the practice of including state severance taxes in calculating "gross proceeds" does not frustrate the intent of the NGPA. Finally, the DOI's practice finds support in the law of this circuit and other circuits.

Accordingly, the judgment of the district court is, in all respects,

AFFIRMED.

APPENDIX B

ENRON OIL & GAS and Belco Petroleum Corporation, Plaintiffs,

v.

Manual LUJAN, Secretary of Interior, United States Department of Interior, Erasmo Gonzales, Area Manager, Houston Area Compliance Officer, and Mineral Management Service, Defendants.

Civ. A. No. H-89-1411.

United States District Court,
S.D. Texas,
Houston Division.

Sept. 16, 1991.

ORDER

RAINEY, District Judge.

The Court has reviewed the Memorandum and Recommendation of Magistrate issued by Judge Stacy (Instrument #69) as well as Plaintiffs" Notice of Objection to Memorandum and Recommendation of Magistrate (Instrument #70) and Defendants' Opposition to Plaintiffs' Notice of Objections to Memorandum and Recommendation of Magistrate (Instrument #71). The Court finds that the Memorandum and Recommendation of Magistrate should be adopted with the following changes:

1. The following sentence at the top of page 4 of the Memorandum: "Principles of sovereign immunity bar the states from assessing taxes on the production from the federal leases.", should be changed to read: "Principles of sovereign immunity bar the states from assessing taxes on the percentage of production from a federal or Indian lease equal to a federal or Indian lessor's reserved royalty."

2. The fourth sentence of the first paragraph on page 10 of the Memorandum should be changed to read as follows: "Royalty in the situation before us is calculated by taking the total of gross proceeds for sale of production from the lease plus tax reimbursements actually received, and multiplying the total by the applicable royalty percentage."

All other objections raised by Plaintiffs are overruled. The Court finds that the Magistrate's recommendation is further strengthened by the Fifth Circuit's recent ruling in *Mesa Operating Ltd. v. United States Dept. of Interior*, 931 F.2d 318 (5th Cir. 1991). This Court therefore holds that the Defendants' Motion For Summary Judgment (Instrument #31) should be granted. It is therefore;

ORDERED that Defendants' Motion For Summary Judgment is granted.

MEMORANDUM AND
RECOMMENDATION
OF MAGISTRATE

FRANCES H. STACY, United States Magistrate Judge.

This suit was brought for review of a decision of the Interior Board of Land Appeals (IBLA), United States Department of the Interior (DOI), in which the IBLA approved the assessment of royalties on payments that Plaintiff Enron Oil and Gas Company (Enron) receives as tax reimbursements from parties to which it sells gas extracted from federal and private leases. The DOI, through its Mineral Management Service (MMS), bases its claims for such royalties on its belief that tax reimbursements are part of the total value for which Enron sells its gas. Enron claims that MMS's royalty calculations are arbitrary and capricious in that they 1) are contrary to prior case law and 2) violate the policy underlying the Natural Gas Policy Act of 1978 so that its current regulations exceed Congress' delegation of authority to the DOI.

The parties have presented to the court for consideration cross motions for summary judgment, styled Plaintiffs' Motion for Summary Judgment (Instrument #28) and Defendants' Motion for Summary Judgment (Instrument #31). A hearing in their regard was held before Magistrate Judge Frances H. Stacy on October 24, 1990. The Magistrate's recommendation for decision was subsequently deferred, pending Fifth Circuit review of a case involving related issues, *Mesa Operating Ltd. Partnership v. United States Dep't of the Interior*, 931 F.2d 318 (5th Cir. 1991). That decision was published on May 15th. The petition filed for rehearing was denied on June 27th.

The parties' motions for summary judgment reveal that there are no genuine issues of material fact to be determined here. The only issues are legal and can be decided on the basis of the motions themselves.

I. BACKGROUND

Enron leases various federal public domain properties in Wyoming and Utah from the Department of the Interior for the purpose of oil and gas exploration and production pursuant to the Mineral Leasing Act of 1920, 30 U.S.C §§ 181 *et seq.* (1982), and the 1938 Omnibus Leasing Act, 25 U.S.C. §§ 396a-396g (1982). Sections 226(b) and (c) of the Mineral Leasing Act require the Secretary of the Interior to collect royalties of twelve and one-half percent "in amount or value of production removed or sold from the lease" on such leases, and section 189 authorizes him to develop necessary and proper rules and regulations, having the force and effect of statutes when not in conflict with statutes, to carry out the purposes of the act. *Marathon Oil Co. v. United States*, 604 F.Supp. 1375, 1380 (D.Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940, 107 S.Ct. 1593, 94 L.Ed.2d 782 (1987).

The department has formulated the following regulation in regard to calculating royalty:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the

> value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per [unit] paid or offered at the time of production in a fair and open market for the major portion of like-quality ... gas... produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 CFR § 206.103 (1983). The terms of the DOI-Enron leases mirror the language of the act, and require Enron to pay DOI a periodic twelve and one-half percent royalty on all "production removed or sold from the leased lands ...." The leases also state that

> the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all ... gas ... due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters ....

In addition to the federal leases, Enron holds private leases on whose production Utah and Wyoming assess ad valorem and/or severance taxes. Principles of sovereign immunity bar the states from assessing taxes on the production from the federal leases.

In marketing the natural gas production from the various leases, Enron has been able to negotiate contracts with purchasers for an amount which includes the maximum legal price for natural gas allowed by the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982), plus reimbursement of the state taxes it has been required to pay. This is in accordance with the NGPA, which provides at section 3320 that

> (a) ... a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas ... if such first sale price exceeds the maximum lawful price to the extent necessary to recover. --
>
> > (1) State severance taxes attributable to the production of such natural gas and borne by the seller ...; and
> >
> > (2) any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by the Commission.

Before the NGPA was enacted, the MMS included reimbursements for state severance taxes in its determination of gross proceeds and reasonable gas value for purposes of calculating royalties. The Interior Board of Land Appeals upheld the practice in *Wheless Drilling Co.*, 13 I.B.L.A. 21, 8 Interior Dec. 599 (1973), whereupon the DOI issued a Notice to Lessees and Operators of Federal and Indian

Onshore Oil and Gas Leases (NTL-5), 42 Fed. Reg. 22610-22611 (May 4, 1977) affirming the practice, and modified its regulations expressly defining the term "gross proceeds" to include tax reimbursements. 30 C.F.R. § 206.101 (1987).

After passage of the NGPA in 1978, Enron began to calculate and pay royalties on the basis of the maximum legal price allowed under the act, not including tax reimbursements. MMS audited Enron's records in 1986 and determined that, because of the new practice, there were royalty underpayments on various of the leases dating back to 1978. It issued orders on May 7, 1986, demanding additional royalties of $1,052,597.41 for the period of August 1, 1978, through December, 1983; on August 19, 1986, demanding late payment charges in the amount of $435,304.64; and on September 2, 1986, demanding royalties on tax reimbursements after 1983 in the amount of $435,304.64.

Enron paid the demanded royalties under protest and posted bond for the late charges. It then appealed the government's method of royalty calculation to the director of the MMS, who denied the appeal, and hence to the Office of Hearing and Appeals, Interior Board of Land Appeals. After the IBLA affirmed the director's decision, Enron filed the complaint in this action seeking review of the government's royalty demands. While acknowledging the DOI's consistent practice of including tax reimbursements in its determination of product value when calculating royalties, Enron claims that the practice in this case is contrary to prior case law, and that Congress, through the passage of the NGPA in 1978, expressly removed DOI's discretion to include state severance taxes in its calculation of natural gas value.

Standards for Review

Summary judgment should be granted if "there is no genuine issue as to any material fact and ... the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). Because there are no issues of fact still before the Court, determination and application of appropriate law will decide this case.

When an action challenges the legal basis for an IBLA decision, this court must determine whether the decision below is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" "or in excess of statutory ... authority..." 5 U.S.C. §706(2); *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 415-17, 91 S.Ct. 814, 823-24, 28 L.Ed.2d 136 (1971); *Diamond Shamrock Exploration Co. V. Hodel*, 853 F.2d 1159, 1165 (5th Cir. 1988).

Where a statute is silent as to the precise question at issue, the reviewing court must examine whether the agency interpretation is based on a permissible construction of the statute. *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 at 843, 104 S.Ct. 2778 at 2781-82, 81 L.Ed.2d 694 at 703 (1984). While the court must give due deference to an agency's construction of a statute, reviewing courts are not obliged to affirm administrative decisions that are inconsistent with statutory mandates or their underlying policies. *Tex. Power & Light Co. v. Fed. Communications Comm'n*, 784 F.2d 1265, 1269 (5th Cir. 1986).

II. DISCUSSION

This is a case where relevant statutes are silent as to the precise question at issue, namely, whether the DOI may

properly include tax reimbursements in its determination of production value when calculating royalties. The reviewing court in such a case must decide whether the agency determination of such value is based on a permissible interpretation of the statute.

Existing case law upholds the DOI's practice of assessing royalties on a production value that includes tax reimbursements.

What is the value of production? Is it contract price, or contract price, plus severance? The latter is the value of production for payment of royalties.

Hoover & Bracken Energies v. United States Dep't of Interior, 723 F.2d 1488 (10th Cir. 1983).

> (T)he base value for computation of the federal royalty in this case must include both the gas purchase price and the reimbursed severance tax.

Wheless Drilling Co., 13 I.B.L.A. 21, 8 Interior Dec. 599 (1973). Enron argues that *Hoover & Bracken's* reliance on *Wheless* is misplaced in light of the enactment of the NGPA in 1978, and urges that the Court adopt instead the reasoning in the *Hoover & Bracken* dissent.

As the dissent notes, Congress intended that the NGPA provide incentives to producers for the exploration and production of low-grade natural gas through, among other things, allowing producers to negotiate a sale price which could include both the maximum legal price for such gas plus reimbursement for certain post-production costs under section 110(a)(2) and/or state severance taxes under section 110(a)(1) of the Act. Enron and the *Hoover &*

Bracken dissent interpret this to mean not only that Congress intended producers to receive the maximum legal price undiluted by severance taxes but, by extension, that Congress intended such taxes to be excluded from the value on which royalty is assessed.

Section 110(a)(1) of the NGPA specifically provides that the maximum legal price for gas should not be reduced by severance taxes, but nowhere in the Act does Congress indicate any concern with royalties, a fact that Enron and the *Hoover & Bracken* dissent ignore. If Congress had intended to alter the royalty calculation scheme in place at the DOI, it could have done so, but it did not. We find no specific indication that Congress meant, through the NGPA, to address assessment of royalties in any fashion.

In *Mesa Operating Ltd, v. United States Dep't of Interior*, 931 F.2d 318 (5th Cir. 1991), the Fifth Circuit addressed section 110(a)(2) of the NGPA, companion to section 110(a)(1) at issue in the present case, and held that assessment of royalties on a product value that includes post-production costs is proper. As the Court explained, "[t]he DOI-lessor simply obtains a flat percentage of all 'gross proceeds' whether they be within the ceiling price or exceed it under § 110, obtaining more royalty where the lessee obtains a greater price, including costs reimbursements, from the pipeline purchaser." The statement applies equally to the gross proceeds factor in determining product value under § 110(a)(1).

Enron argues that the case before us is distinguishable from *Mesa* because federal leases are exempt from paying severance taxes but not from post-production costs. While Enron's position is not without a certain logic, it must be remembered that the DOI does not assess royalty on some value defined by abstract distinctions between federal leases

and private leases, or communitized leases or non-communitized leases. Rather, royalty is assessed on value of production as reflected by the market. In the marketplace, Enron is able to sell its gas for a maximum legal price plus reimbursement of the severance tax. If it were able only to sell the gas at some lower price, excluding tax reimbursement, then royalty would of course be assessed on the basis of a lower value. The question before us is not whether the method used by DOI to calculate royalties is the best or the fairest, but rather, whether the method chosen is a reasonable one under the regulations, and within the authority given to the department by the Congress.

In its Response to Defendant's Supplemental Notice of Additional Authority, Instrument #67, page 3, Enron states, "[i]n the present case, the states never charged any severance taxes against the government's share, Enron never paid any, and Enron never got reimbursed for any." This is true. What is also true, but what Enron fails to add, is that Enron does not pay royalty on any reimbursements that Enron does not actually receive.

Royalty is reasonably assessed only on proceeds that are actually received. Whether or not the federal government pays state taxes on production from federal leases is unimportant. What is material is what Enron actually receives for the gas it sells. Royalty in the situation before us is calculated by taking the total of gross proceeds for sale of product for all the properties plus tax reimbursements actually received for all the properties, and multiplying the total by the applicable royalty percentage and the percentage of the lease total represented by the federal interest. That is a permissible interpretation of the statutes and regulations as they apply to the facts of this case.

III. CONCLUSION

The DOI has consistently calculated royalties for federal natural gas leases on a value of production which reflects the market value of like-quality gas in the same field. Where the sale of such gas garners not only the maximum legal price under the NGPA, but also tax reimbursements, it is rasonable [sic] and permissible for the DOI, and not in conflict with the NGPA, to include the tax reimbursements actually received by the seller in the total amount on which the DOI assigns its royalty percentage.

The decision by the IBLA to include the value of tax reimbursements actually received in value of product for royalty calculations was neither arbitrary, capricious, an abuse of discretion, nor contrary to law. The DOI made a reasonable and permissible interpretation of its regulations governing royalties owed on federal natural gas leases, and neither the regulations nor their interpretation exceeded authority granted to it by Congress.

The Clerk shall file this instrument and mail a copy to all parties. Within 10 days after being served with a copy, any party may file written objections pursuant to 28 U.S.C. § 636(b)(1)(C), General Order 80-5, S.D. Texas. Failure to file objections within such period shall bar an aggrieved party from attacking factual findings on appeal. *Nettles v. Wainwright*, 677 F.2d 404 (5th Cir. 1982) (*en banc*); *Ware v. King*, 694 F.2d 89 (5th Cir. 1982); *Thomas v. Arn*, 474 U.S. 140, 106 S.Ct. 466, 88 L.Ed.2d 435 (1985). The original of any written objections shall be filed with the U. S. District Clerk, P. O. Box 61010, Houston,

Texas 77208 and a copy shall be delivered to the Chambers of Judge Rainey, Room 8613 and to the Chambers of Judge Stacy, Room 7525.

Signed at Houston, Texas on this the 7th day of August, 1991.

APPENDIX C

UNITED STATES DEPARTMENT OF THE INTERIOR

OFFICE OF HEARINGS AND APPEALS
INTERIOR BOARD OF LAND APPEALS
4015 WILSON BOULEVARD
ARLINGTON, VIRGINIA 2203

ENRON CORP.

IBLA 87-804 Decided January 23, 1989

Appeal from a decision of the Director, Minerals Management Service, denying appeals from orders to pay additional royalties and late payment charges. MMS-86-0399-O&G, MMS-86-0483-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties

Where natural gas produced from Federal leases is sold under an arrangement where the buyers pay the maximum lawful price allowed under the Natural Gas Policy Act of 1978 and, in addition, reimburse the producer/seller for severance taxes it paid to the State of Wyoming, the gross proceeds received by the producer/seller from the leases consist of the maximum Natural Gas Policy Act price *plus* the tax reimbursements. Accordingly, in computing the "value" of the gas produced from these leases, MMS properly determines that the "gross proceeds" to which the royalty rate applies include the purchase price plus the

tax reimbursements and properly demands additional royalty and late payment charges where royalty payments were made using a value that excluded the severance tax reimbursements.

APPEARANCES: Dante L. Zarlengo, Esq., Denver, Colorado, for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., and Geoffrey Heath, Esq., Office of the Solicitor, for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

Enron Corporation (Enron)[1] has appealed from the June 29, 1987, decision of the Director, Minerals Management Service (MMS) (MMS-86-0399-O&G and MMS-86-0483-O&G), denying an appeal from three different orders requiring the payment of additional royalties and interest thereon for failure to include in the value of production reimbursements received by Enron from its customers for state severance taxes paid by Enron.[2]

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1. These appeals were originally brought by Belco Petroleum Corporation, Belco Development Corporation, and Bel North Petroleum Corporation. Counsel for Enron states: "Enron Oil and Gas Company has succeeded by merger to the interest and liabilities, if any, of Belco Development Corporation, and Bel North Petroleum Corporation. Belco Petroleum Corporation and Enron Oil and Gas Company are both subsidiaries of Enron Corp." Counsel for Enron refers to all of these entities as "Enron." So shall we.

2. The Director's decision denied appeals from three separate orders: (1) a May 7, 1986, order to pay $1,052,597.41 additional royalties on reimbursed state ad valorem severance taxes for gas produced on Federal onshore leases from 1977 through 1983; (2) an Aug. 19, 1986, order to pay $685,253.50 interest due on the royalties due under the May 7, 1986, order; and (3) a Sept. 2, 1986, order to pay royalty on reimbursed state ad valorem severance tax on gas production after 1983.

The State of Wyoming (the State) imposes an ad valorem severance tax on the sale of gas production from wells within the State. By agreement with Enron, the purchasers of gas from the subject leases not only pay Enron the maximum lawful price allowed under the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3422 (1982), but they also reimburse Enron for the severance tax. Thus, the total compensation Enron receives from its customers consists of the maximum lawful NGPA price plus the tax reimbursements. MMS determined that Enron was required to include the amount attributable to the reimbursement of severance tax in determining the gross proceeds of the lease to which the royalty rate was to be applied. Enron contends that the tax reimbursements must be excluded.

[1] Federal oil and gas lessees are required to pay a royalty of "12-1/2 per centum in amount or value of the production reserved or sold from the lease." 30 U.S.C. § 226(b) and (c) (1982). When royalty is not taken in kind, it is calculated as 12-1/2 percent of the value of production from the lease. The Mineral Lands Leasing Act of 1920, *as amended*, 30 U.S.C. § 181 (1982), reserves to the Department the authority and responsibility to establish reasonable value for royalty purposes. *Marathon Oil Co. v. United States*, 604 F. Supp. 1375, 1381 (D. Alaska 1985), *aff'd*, 794 F.2d 1461 (9th Cir. 1986); *accord, California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961); *Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950); *United States v. Ohio Oil Co.*, 163 F.2d 633, 639-40 (10th Cir. 1947), *cert. denied*, 333 U.S. 833 (1948). Departmental rules for determining value for royalty purposes are set forth at 30 CFR 206.103 (formerly 30 CFR 221.47), which states:

> The value of production, for the purpose of computing royalty, shall be the

> estimated reasonable value of the product as determined by the Associate Director [of MMS,] due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. *Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary.* In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. [Emphasis added.]

It has been well established for many years that severance tax reimbursements made by the buyer of gas produced from Federal wells to the Federal lessee/producer/seller are properly included as part of the gross value of the production in computation of the royalty due to the Government. *Tricentrol United States, Inc.*, 105 IBLA 392 (1988); *Amoco Production Co.*, 29 IBLA 234, 235 (1977); *Wheless Drilling Co.*, 13 IBLA 21, 80 I.D. 599 (1973); *see Hoover & Bracken Energies, Inc.*, 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, *Hoover & Bracken Energies, Inc. v. U. S. Department of the Interior*, 723 F.2d 1488 (10th Cir.

1983), *cert. denied*, 469 U. S. 821 (1984).[3] The reasons for this rule are set out in *Wheless*, which presented circumstances virtually identical to those present here:

> It seems obvious to us that the buyer is paying to the seller an amount greater than the established field price for the natural gas it purchases from the * * * well. It follows, therefore, that it is reasonable to compute the Federal royalty of the natural gas taken from this well on a unit value consisting of the field price established by [the Federal Power Commission] plus the amount of the severance tax reimbursed by the buyer. Within the context of 30 CFR 221.47, "gross proceeds" means the established field price for the natural gas plus any additional sums paid by the producer of the gas to the unit operator as consideration for the purchase of gas from the unit of which the federal lease is a part.

13 IBLA at 30, 80 I.D. at 603. We also specifically held in *Wheless* that "gross proceeds" consisted of "the gas purchase price plus the reimbursed severance tax." 13 IBLA at 32, 80 I.D. at 604.

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3. In *Hoover & Bracken Energies, Inc.*, *supra*, we considered a slightly different situation than that presented in this case. Under Oklahoma law, state severance tax must be paid by the buyer, rather than by the producer/lessee/seller, as is the case in Wyoming. In *Hoover*, the buyer agreed both to pay the NGPA ceiling price and to pay the state severance tax. We ruled that, even though the obligation to pay under Oklahoma law rested with the buyer, its willingness to pay the severance tax in addition to the maximum NGPA price established a "value" for the gas equal to the actual price to the buyer, that is, the NGPA price plus the severance tax. 52 IBLA at 36, 88 I.D. at 12.

Since *Wheless*, the rule that gross proceeds shall include tax reimbursements has been widely disseminated. It was set out expressly more than 11 years ago in Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases-1 (NTL-1), 42 FR 4546 (Jan. 25, 1977), which states in pertinent part:

> Under no circumstances will the royalty value be computed on less than the gross proceeds accruing to the operator from the sale of such leasehold production. *Gross proceeds include*, * * * *tax reimbursements* and payments to the operator for gathering, measuring, compressing, dehydrating, or performing other services necessary to market the production. [Emphasis added.]

The same rule was also published in NTL-5, 42 FR 22610, 22611 (May 4, 1977). While this appeal was pending, Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1987, P.L. 100-234, 101 Stat. 1719 (1988). Although Congress modified one part of the NTL-5, it left intact, and thus effectively ratified, the requirement that tax reimbursements be included in calculating gross proceeds.[4]

Nevertheless, Enron contends that basing a royalty calculation on tax reimbursements is arbitrary, capricious,

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4. This legislation enacted a change in one requirement of NTL-5 with respect to production from 1982 to 1986 from certain wells. Under NTL-5, the base value for royalty purposes was either the actual price received or the ceiling price, whichever was *higher*. After 1982, actual gas prices in many areas declined below the ceiling price, but the lessees were still required to base the royalty on the ceiling price. The new statute provided that the value of production for certain leases between 1982 and 1986 would be based on the actual price received. This provision does not apply to this appeal.

and an abuse of discretion. Enron suggests that *Hoover & Bracken* is not applicable because that case involved a communitization of several leases and "the court held in effect that the government's share of production was indistinguishable from every other royalty owner's share because of the communitization agreement." Enron contends that under Wyoming law "[a]s between landowners royalty and other portions of production from a well, the tax is calculated separately, assessed separately, and collected separately." This argument is unavailing. Under 30 CFR 206.103, the value of the Federal royalty gas can be no less per unit than the value of other gas of the same quality from the field. This requirement prevents the producer from assigning a lower value to the Federal royalty gas than to other gas having the same characteristics. The value of a unit of gas is what a buyer is willing to pay for it. Enron's customers are willing not only to pay the NGPA price but also pay the severance tax. Thus, the true value to Enron's customers for each unit of gas from the subject leases is the sum of the NGPA price and the tax reimbursements.

Enron, as Federal lessee/producer/seller could presumably have struck a bargain to sell the gas for the NGPA price alone, under which arrangement its payment of the state severance tax would effectively have reduced its proceeds from the sale. [5] However, it was able to find a buyer which valued the gas highly enough to be willing to pay both the NGPA price and to reimburse it for its severance tax payments. As we noted in *Hoover & Bracken Energies, Inc.*, 52 IBLA at 31, 88 I.D. at 11, sec. 110(a) of NGPA, 15 U.S.C. § 3320(a) (1982), expressly provides that

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5. Enron's statement of reasons suggests that the reimbursement of state severance tax payments by a purchaser is negotiable: "Some gas purchase agreements require the purchaser to reimburse Enron for ad valorem taxes." Presumably, other agreements do not.

a price for the first sale of natural gas will not be considered to exceed the maximum lawful price if the first sale price exceeds the maximum lawful price to the extent necessary to recover state severance taxes attributable to the production of such natural gas and borne by the seller. Thus, it was apparently permissible for Enron to increase its receipts by allowing its buyer to reimburse it for the state severance tax owed on the production. However, doing so increased the amount of the proceeds it received and, as a result, increased the amount of the royalty due to the United States.

Enron contends that the royalty valuation based upon tax reimbursements is contrary to the requirement of 30 CFR 206.103 that provides that royalty production be valued comparatively with other production of like quality. Enron maintains that Government production is materially different from other production from the same well because it is not subject to state taxation, so that the regulation requires comparative valuation to other tax-free production. Such a construction of the regulation is untenable because it defeats the regulation's purpose of ensuring that Federal gas having the same physical properties as other gas from the same field is not assigned a lower value. We have previously observed:

> The fact that the United States cannot be assessed state severance tax does not depreciate the *value* of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the state from assessing a severance tax. This benefit flows to the Government, not the lessor.

Hoover & Bracken Energies, Inc., 52 IBLA at 37, 88 I.D. at 12, quoted with approval in *Hoover & Bracken Energies, Inc. v. U. S. Department of the Interior*, *supra* at 1491.

Finally, Enron argues that the valuation of production to include tax reimbursements violates the provisions of the NGPA. Enron contends that the *Wheless Drilling Co.* decision is no longer valid because the application of its analysis after passage of the NGPA would place the value of the Government's royalty share above the maximum lawful NGPA price. Enron misconceives the intent of the legislation and overstates its effect. The legislation affected the price that producers could charge their customer, but Enron cites no language in the Act or its legislative history indicating that Congress intended to change any existing royalty obligations between the lessees and the Government. Congress has specifically addressed such matters when it perceived that a change was needed. *E.g.*, NTL-5 Gas Royalty Act of 1987, *supra*. The court's *Hoover* decision rejected arguments similar to Enron's and held: "The recent enactment of the NGPA does not affect the soundness of the reasoning present in *Wheless*." 723 F.2d at 1493.

Enron offers no specific reasons that MMS' imposition of late payment charges was incorrect. However, it would follow that late payment charges would not be due if it were not required to pay the royalty in the first place. Inasmuch as we have held that Enron was properly required to pay the additional royalty, MMS' decision requiring it to pay late payment charges must also be affirmed.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

/s/ David L. Hughes
David L. Hughes
Administrative Judge

I concur:

Kathryn A. Lynn

Kathryn A. Lynn
Administrative Judge
Alternate Member

APPENDIX D

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 91-6161

ENRON OIL & GAS COMPANY and BELCO PETROLEUM CORPORATION,
Plaintiffs-Appellants,

versus

MANUEL LUJAN, Secretary of Interior, ET AL.,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of Texas

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ON PETITION FOR REHEARING

(JANUARY 27, 1993)

Before JONES and BARKSDALE*, Circuit Judges, and JUSTICE *, District Judge.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT: (Stamp illegible)

/s/ illegible
United States Circuit Judge

*District Judge from the Eastern District of Texas, sitting by designation.

APPENDIX E

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
HOUSTON REGIONAL COMPLIANCE OFFICE
4141 NORTH BELT EAST, SUITE 350
HOUSTON, TEXAS 77032

IN REPLY
REFER TO
MS
MMS-RCD-HRCO **AUG 19 1986**

CERTIFIED MAIL -
RETURN RECEIPT REQUESTED

Belco Petroleum Corporation
Attention: Mr. John Cobb, Controller
10000 Old Katy Road, Suite 100
Houston, Texas 77055

Re: Interest Due on Reimbursed Ad Valorem Taxes for Production Years 1977 through 1983.

Gentlemen:

The Minerals Management Service (MMS) has determined that as a result of our letter dated May 7, 1986, Belco Petroleum Corporation (Belco) made a payment of $1,052,628.15 on June 9, 1986. Belco's payment was for additional royalties assessed because Belco routinely failed to pay to MMS its royalty share of reimbursed ad valorem taxes accruing as additional gross proceeds from the sale of the

production from the leases. Belco is directed to pay late payment charges of $685,253.50 on the above amount pursuant to 30 CFR 218.54

[. . .]

Payment in the form of a check made payable to MMS is due by the date indicated on the bill issued by MMS. The check and attachments must be mailed to the address indicated on the bill and a copy of the bill for collection must be included with your check to assure proper credit to your account.

Section 109 of the Federal Oil and Gas Royalty Management Act (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order, lease or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51(a)(3) and could subject you to penalties of up to $5,000 per violation per day.

You have the right to appeal in accordance with the provision of 30 CFR 290. Any appeal taken will be to the Director, MMS, and the notice of appeal must be filed within 30 days from the receipt of this directive with:

Erasmo Gonzales
Regional Manager
Houston Regional Compliance Office
Minerals Management Service
4141 North Belt East, Suite 350
Houston, Texas 77032

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of the directive. Within the same 30-day

period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, MMS, and such motion should be filed with the Director who may, in his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any documents in connection with an appeal may be extended by the Director, MMS. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2, payment of this bill shall not be suspended by reason of an appeal having been taken. An option is available to post a bond as surety in lieu of paying, pending the outcome of the appeal. A request to post a bond must be made within 30 days from the receipt of the directive and sent to the address indicated above.

If additional information is needed, please contact Marjorie Swartz at (713) 229-3787.

Sincerely,

/s/ illegible
Erasmo Gonzales
Regional Manager
Houston Regional Compliance Office

Enclosures

APPENDIX F

UNITED STATES DEPARTMENT OF THE INTERIOR

MINERALS MANAGEMENT SERVICE
HOUSTON REGIONAL COMPLIANCE OFFICE
4141 NORTH BELT EAST, SUITE 350
HOUSTON, TEXAS 77032

IN REPLY REFER TO:
MS
MMS-RCD-HRCO **SEP 02 1986**

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Belco Petroleum Corporation
Attention: Mr. John Cobb, Controller
10000 Old Katy Road, Suite 100
Houston, Texas 77055

Re: Royalties Due on Reimbursed Ad Valorem Taxes for Production Year 1984

Gentlemen:

The Houston Regional Compliance Office (HRCO) of the Minerals Management Service (MMS) is reviewing royalties paid by Belco Petroleum Corporation (Belco) on Federal and Indian leases for August 1, 1978, through July 31, 1984. Based upon its review, the HRCO concluded that Belco had routinely failed to pay the Federal royalty share of actual reimbursed ad valorem taxes accruing to Belco from the sale of natural gas produced from Federal onshore leases. By letter dated May 7, 1986, the HRCO demanded payment of additional royalties in the amount of $1,052,597.41 which

represented the royalty underpayment through December 31, 1983. The HRCO has reason to believe that Belco has not paid the Federal royalty share of actual reimbursed ad valorem taxes for any period after December 31, 1983.

Federal regulations and instructions from MMS establish the value to be used in calculating royalties for Federal and Indian leases. Title 30 of the Code of Federal Regulations (CFR), Section 206.103, entitled "Value basis for computing royalties." states in part:

> "The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be *less than the gross proceeds* (emphasis added) accruing to the lessee from the sale thereof . . . ."

Gross proceeds from the sale of oil or gas, which is the minimum royalty value under 30 CFR 206.103 is properly measured by considering the total proceeds paid by the purchaser.

Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5), *Value of Natural Gas for Royalty Purposes*, governs the valuation of Federal onshore gas production for royalty purposes. Section I.D. of NTL-5 states in part:

> ". . . All gathering, tax reimbursement, adjustments authorized by FPC, and other factors, as described by Section V of this Notice, will also be considered by the Supervisor in determining the value used for royalty computation purposes."

Section V.A. of NTL-5 states that " . . . Gross proceeds include, but are not limited to, tax reimbursements and payments to the lessee or operator . . . ."

The *Payor Handbook Addendum No. 16, MMS-2014 Requirements for Tax Reimbursements*, describes the procedures for reporting royalties on tax reimbursements.

In order to bring royalty payments into compliance with 30 CFR 206.103, NTL-5, and MMS instructions, Belco is hereby directed to calculate and pay all additional Federal royalties due on the reimbursed ad valorem taxes for all periods beginning January 1, 1984. Payment in the form of a check made payable to MMS and appropriate *green* Forms MMS-2014 are due within 60 days from the date of receipt of this letter. Appropriate late payment charges pursuant to 30 CFR 218.54 will be computed and billed to Belco upon receipt of payment of the additional royalties due.

A copy of Belco's check, the *green* Forms MMS-2014, and documentation supporting Belco's calculations must be forwarded to the address shown below.

Section 109 of the Federal Oil and Gas Royalty Management Act (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order, lease or permit. Consequently, your failure to comply with the terms of this order may be

considered a violation pursuant to 30 CFR 241.51 (a)(3) and could subject you to penalties of up to $5,000 per violation per day.

You have the right to appeal in accordance with the provisions of 30 CFR 290. Any appeal taken will be to the Director, MMS, and the notice of appeal must be filed within 30 days from the receipt of this directive with:

Erasmo Gonzales
Regional Manager
Houston Regional Compliance Office
Minerals Management Service
4141 North Belt East, Suite 350
Houston, Texas 77032

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, MMS, and such motion should be filed with the Director who may, in his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any documents in connection with an appeal may be extended by the Director, MMS. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2 compliance with this letter shall not be suspended by reason

of an appeal having been taken. An option is available to post a bond as surety in lieu of paying, pending the outcome of the appeal. A request to post a bond must be made within 30 days from the receipt of the directive and sent to the address indicated above.

If additional information is needed, please contact Marjorie Swartz at (713) 229-3787.

Sincerely,

/s/ Erasmo Gonzales
Erasmo Gonzales
Regional Manager
Houston Regional Compliance Office

Enclosures

APPENDIX G

UNITED STATES DEPARTMENT OF THE INTERIOR

MINERALS MANAGEMENT SERVICE
WASHINGTON, DC 20240

JUN 29 1987

MMS-86-0399-O&G	**:Onshore Federal Leases**
MMS-86-0483-O&G	**:**
	:
Belco Petroleum	**: Royalty on Reimbursement**
Corporation	**: for State Severance Tax**
	:
Appellant	**: Appeal Denied**

Belco Petroleum Corporation (Belco) appealed under 30 CFR Part 290 from (1) a May 7, 1986, order to pay $1,052,597.41 additional royalties on reimbursed State ad valorem severance taxes for gas produced on Federal onshore leases, from 1977 through 1983; (2) an August 19, 1986, order to pay $685,253.50 interest on the royalties due under the May 7, 1986, order; and (3) a September 2, 1986, order to pay royalty on reimbursed State ad valorem severance tax on gas production after 1983.

Facts

The State of Wyoming imposes an ad valorem severance tax on the sale of gas production from wells within Wyoming. A portion of the production, equal to the Federal royalty share, is exempt from the Wyoming severance tax. The Appellant's purchaser reimburses the Appellant for the State severance tax.

Appellant's Arguments

The Appellant raises numerous arguments to the effect that it is improper to assess a royalty on funds paid to the Appellant as reimbursement of a State ad valorem severance tax. The Appellant also argues that the May 7, 1986, order is unenforceable because it is not specific enough for the Appellant to allocate the $1,052,597.41 to its numerous leases. The Appellant also argues that the facts in this appeal are distinguishable from those in *Wheless Drilling Company, 13 IBLA* 21 (1973), and *Hoover & Bracken Energies, Inc.*, 52 IBLA 27 (1981), because the Appellant's leases are not communitized, whereas the leases in *Wheless Drilling Company* and *Hoover & Bracken Energies, Inc.* were communitized. The Appellant further asserts that since the May 7, 1986, order is not valid, it follows that the two subsequent orders being appealed are also invalid.

Analysis

The Mineral Leasing Act of 1920 30 U.S.C. 226 (1982) requires the payment of a royalty applied against the value of the oil and gas production. The lessor's royalty valuation regulations for oil and gas provide in 30 CFR 206.103 (formerly 30 CFR 221.47) that:

> [u]nder no circumstances shall the value of production * * * for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sales thereof * * *.

This provision has been in the regulations over four decades. Since 1977, the regulations have been supplemented by Notice to Lessees and Operators of Federal and Indian

Onshore Oil and Gas Leases (NTL-5) which provides in Section V.A.:

> Under no circumstances will royalty be computed on less than the gross proceeds accruing to the lessee or operator from the sale of leasehold production. Gross proceeds include, but are not limited to, tax reimbursements * * *.

Therefore, it has been the consistent position of the Federal lessor that a royalty is due on a reimbursement of State severance tax.

The issue as to whether the reimbursement of a severance tax should be considered as part of the gross proceeds received by the producer, and therefore subject to a royalty payable thereon, has been challenged. Lessees have argued that the severance tax should be ignored when computing the value of the production, since a portion of the production equivalent to the royalty owner's share has been exempted from the State severance tax. It is noted that the U. S. District Court for the Western District of Oklahoma accepted this argument in *Hoover & Bracken Energies, Inc.*, Civ. 81-461-T, Nov. 18, 1981. However, the U. S. Court of Appeals for the Tenth Circuit reversed the District Court.

This issue has been appealed to the Director of the Minerals Management Service (MMS) and has also been appealed to the Interior Board of Land Appeals (IBLA). *Wheless Drilling Company* and *Hoover & Bracken Energies, Inc.* The issue has also been litigated in the Federal courts. *Hoover & Bracken Energies, Inc., v. United States Department of the Interior*, 723 F.2d 1488 (10th Cir. 1983) *cert. denied*, 105 S.Ct. 93 (1984).

In the above-cited decisions the IBLA and the U.S. Court of Appeals for the Tenth Circuit upheld the MMS position that the gross proceeds from the sale of the production, which is the minimum royalty value under 30 CFR 206.103, is properly measured by including reimbursement for State ad valorem taxes. The Supreme Court has refused to consider the challenge to the decision of the Court of Appeals for the Tenth Circuit.

The Appellant's argument that it is unaware of how to allocate the $1,052,597.41 assessment among the Appellants's numerous leases cannot be accepted. The assessment was derived from forms submitted by the Appellant. A lessee is required to file a report, Form MMS-2014, each month containing the production information relevant to the computation of the royalty payable. In addition, the Appellant prepared separate composite MMS-2014 forms for each lease, for each year. The information from those composite MMS-2014 forms was the basis for the May 7, 1986, order. Since the Appellant prepared the composite MMS-2014 forms which are the basis of the assessment, the Appellant's argument about not knowing how to allocate the assessment is not convincing.

The precedent cases, *Wheless Drilling Company* and *Hoover & Bracken Energies, Inc.*, involved leases that were communitized. However, the decisions in those cases were not dependent upon the fact that the leases were communitized. The principle enunciated in these cases is that a royalty is payable on the value of the production; the amount paid by the purchaser to the producer is a valid measurement of the value; and any payment identified as a reimbursement of State severance tax is a portion of the gross proceeds.

In rejecting the lessee's argument that the severance tax should not generate a royalty because the Federal royalty interest is exempt from the tax, the U. S. Court for the Tenth Circuit said in *Hoover & Bracken Energies, Inc.* at 1491:

> The fact that the United States cannot be assessed State * * * [severance] tax does not depreciate the value of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the State from assessing a severance tax. This benefit flows to the Government, not the * * * [lessee].

The Court summarizes its decision by saying at 1492:

> In the following analysis, the problem boils down to the following. First, the value of production is basic for payment of royalties. Second, the gas is sold to a buyer. Third, the maximum price allowed by law includes the severance tax. Oklahoma has its tax, but federal lands are exempt from it. Fourth, the buyer pays it. The seller has received the contract price, plus severance tax. The gas producer says, in effect, 'we only owe royalties on the contract price received. Our lease says value of production. What is the value of production? Is it contract price, or contract price, plus severance?' The latter is the value of production for payment of royalties.

The logic used in these precedent cases is not limited to leases that are communitized. The fact that the precedent

decisions indicate that decisions in favor of the lessees would negate the communitization agreements is merely an additional reason for a decision in favor of the lessor; it does not mean that the holding applies only to communitized leases. The logic applied by the courts applies equally to a communitized lease and to a lease that is not communitized.

Because of the lease terms, the applicable statute, the regulations, and the cases cited herein the May 7, 1986, order was a proper exercise of the lessor's discretion. By this decision, the valuation portion of the May 7, 1986, assessment is affirmed.

Appellant has also appealed the August 19, 1986, assessment of late payment charges premised on the facts described above.

It is the policy of MMS to assess late payment charges on all debts not received by the due date. Sections 218.54 and 218.102 of 30 CFR provide that the failure to make timely payments under leases will result in the collection of late payment charges. *See also* 30 U.S.C. 1721(a).

The charges for late payment are intended to compensate for the replacement cost of funds due but not paid on a timely basis. The charges are not a penalty. They arise from bona fide expenses and are equivalent to the time value of money. *Peabody Coal Co. and Hopi Indian Tribe*, 72 IBLA 337 (1983); *Atlantic Richfield Company*, 21 IBLA 98 (1975).

The appeal of the September 2, 1986, order involves the same issues as the appeal of the May 7, 1986, order but

is merely applicable to a later time period. For the reason described above, the order applicable to the later time period is also a proper exercise of the lessor's discretion.

Conclusion

The May 7, 1986, order, the August 19, 1986, order, and the September 2, 1986, order are affirmed.

This decision may be appealed to IBLA pursuant to 30 CFR Part 290 and 43 CFR 4.411 and 4.413. A copy of 43 CFR 4.411 and 4.413 is enclosed for reference.

/s/ illegible
Director

Enclosure

APPENDIX H

UNITED STATES DEPARTMENT OF THE INTERIOR

MINERALS MANAGEMENT SERVICE
HOUSTON REGIONAL COMPLIANCE OFFICE
4141 NORTH BELT EAST, SUITE 350
HOUSTON, TEXAS 77032

IN REPLY
REFER TO MS **MAY 7 1986**
MMS-RCD-HRCO

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Belco Petroleum Corporation
Attention: Mr. John Cobb, Controller
10000 Old Katy Road, Suite 100
Houston, Texas 77055

Re: Royalties Due on Reimbursed Ad Valorem Taxes for Production Years 1977 through 1983

Gentlemen:

The Minerals Management Service (MMS) reviewed royalties paid by Belco Petroleum Corporation (Belco) on various Federal onshore leases for August 1, 1978, through July 31, 1984. From our review, we have determined that Belco has routinely failed to pay to MMS the royalty share of ad valorem taxes reimburse to Belco and accruing as additional gross proceeds from the sale of the production from the leases. We conclude that, through December 1983, Belco owes MMS additional royalties of $1,052,597.41 on various onshore leases. (See Exhibit I.)

By letter dated March 6, 1986, MMS apprised Belco of its preliminary determination that Belco owed additional royalties of $1,052,597.41. By letter dated April 8, 1986, Belco responded to MMS's preliminary determination. In its response, Belco stated that:

> " . . . tax reimbursements not attributable to the government's tax exempt interest in production cannot be utilized in computing value of the government's interest in production.
>
> * * *
>
> . . . the MMS' position results in the receipt by the government of a price in excess of the Maximum Lawful Prices set forth in the Natural Gas Policy Act of 1978 . . .
>
> * * *
>
> . . . the receipt by the government of a portion of such reimbursement in addition to the Maximum Lawful Prices for such production under the NGPA results in the receipt by the government of royalty predicated upon a price and value in excess of what may lawfully be collected under the NGPA."

MMS has considered Belco's position and finds it in conflict with the requirements of 30 CFR 206.103 and NTL-5. Belco's position is rejected for the reasons discussed below.

Federal regulations and instructions from MMS establish the value to be use in calculating royalties for Federal and Indian leases. Title 30 of the Code of Federal Regulations (CFR),

Section 206.103, entitled "Value Basis for Computing Royalties," states in part:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field , to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be *less than the gross proceeds* (emphasis added) accruing to the lessee from the sale thereof . . . .

Further, the Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5), *Value of Natural Gas for Royalty Purposes*, is the principal rule governing the valuation of Federal onshore gas production. Section I. D. of NTL-5 states in part:

> . . . All gathering, tax reimbursement, adjustments authorized by FPC, and other factors, as described by Section V of this Notice, will also be considered by the Supervisor in determining the value used for royalty computation purposes.

Section V of NTL-5 states that "gross proceeds include, but are not limited to, tax reimbursements and payments to the lessee or operator. . . ."

The clear language of 30 CFR 206.103 specifies that all relevant matters be considered in determining a reasonable value. A relevant factor in valuing production is found under 15 U.S.C. 3320(a) of the Natural Gas Policy Act (NGPA):

> (a) Allowance for State severance taxes and certain production-related costs. -- Except as provided in subsection (b) of this section, a price for the first sales of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover --
>
> > (1) State severance taxes attributable to the production of such natural gas and borne by the seller, but only to the extent the amount of such taxes does not exceed the limitation of subsection (b) * * *

The policy followed by MMS has been appealed to the Interior Board of Land Appeals [*Wheless Drilling Company*, 13 IBLA 21, and *Hoover and Bracken Energies, Inc.*, 52 IBLA] and has been litigated in the Federal courts. [See *Hoover & Bracken Energies, Inc. v. United States Department of the Interior*, 723 F.2d 1488 (10th Cir. 1983) *cert. denied*, 105 S.Ct. 93 (1904).]

The *Wheless* decision has been in effect since 1973 and has been utilized by lessees and lessors for as long.

In order to bring royalty payments for the referenced leases

into compliance with 30 CFR 206.103 and NTL-5, Belco is directed to pay the additional royalties due of $1,052,597.41. MMS will seek additional royalties for periods after December 1983 in a separate demand action. Appropriate late payment charges pursuant to 30 CFR 218.102 will be computed and billed to Belco upon receipt of payment of the additional royalties due.

Payment in the form of a check made payable to the MMS is due by the date indicated on the bill issued by MMS. The check and attachments must be mailed to the address indicated on the bill and a copy of the bill for collection must be included with your check to assure proper credit to you account.

Section 109 of the Federal Oil and Gas Royalty Management Act (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51(a)(3) and could subject you to penalties of up to $5,000 per violation per day.

You have the right to appeal in accordance with the provisions of 30 CFR 243. Any appeal taken will be to the Director, MMS, and the notice of appeal must be filed with:

Erasmo Gonzales
Regional Manager
Minerals Management Service
Houston Regional Compliance Office
4141 North Belt East, Suite 350
Houston, Texas 77032

within 30 days from the date of receipt of this letter.

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request to present oral argument or evidence to the Director, MMS, and such motion should be filed with the Director who may, in his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any documents in connection with an appeal may be extended by the Director, MMS. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2, compliance with this letter shall not be suspended by reason of an appeal having been taken.

If additional information is needed, please contact Marjorie Swartz at (713) 229-3787.

Sincerely,
/s/ illegible

Erasmo Gonzales
Regional Manager
Houston Regional Compliance Office

Enclosures

EXHIBIT I

Belco Petroleum Corporation
Audit of Federal and Indian Royalties
Schedule of Additional Royalties Due MMS From
Revenues Received
on Reimbursed Ad Valorem Taxes
Production Years 1977 through 1983

Year	*Royalty Amount*
1977	$ 60,481.63
1978	78,302.06
1979	125,667.22
1980	165,921.70
1981	177,640.09
1982	227,534.18
1983	217,050.53
Total	$ 1,052,597.41

APPENDIX I

30 U.S.C. § 226

§ 226. Lease of oil and gas lands

(a) Authority of Secretary

All lands subject to disposition under this chapter which are known or believed to contain oil or gas deposits may be leased by the Secretary.

(b) Lands within known geologic structure of a producing oil or gas field; lands within special tar sand areas; competitive bidding; royalties

(1) If the lands to be leased are within any known geological structure of a producing oil or gas field, they shall be leased to the highest responsible qualified bidder by competitive bidding under general regulations in units of not more than six hundred and forty acres, which shall be as nearly compact in form as possible, upon the payment by the lessee of such bonus as may be accepted by the Secretary and of such royalty as may be fixed in the lease, which shall be not less than 12 1/2 per centum in amount or value of the production removed or sold from the lease.

(2) If the lands to be leased are within a special tar sand area, they shall be leased to the highest responsible qualified bidder by competitive bidding under general regulations in units of not more than five thousand one hundred and twenty acres, which shall be as nearly compact as possible, upon the payment by the lessee of such bonus as may be accepted by the Secretary. Royalty shall be 12 1/2 per centum in amount or value of production removed or

sold from the lease, subject to subsection (k)(1)(c) of this section. The Secretary may lease such additional lands in special tar sand areas as may be required in support of any operations necessary for the recovery of tar sands.

(c) Lands subject to leasing under subsection (b); first qualified applicant

If the lands to be leased are not subject to leasing under subsection (b) of this section, the person first making application for the lease who is qualified to hold a lease under this chapter shall be entitled to a lease of such lands without competitive bidding. Such leases shall be conditioned upon the payment by the lessee of a royalty of 12 1/2 per centum in amount or value of the production removed or sold from the lease.

[***]

APPENDIX J

30 C.F.R. § 206.103

§ 206.103 Value basis for computing royalties.

The value of production for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.